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The Manufacturers Hanover
Economic Report

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Closing The Gap

It has come to my attention that our forecast of continued expansion in the U.S. economy with a better balance between the service sector and the goods-producing sector has been greeted with more than the usual amount of skepticism. This is because it hinges to a great extent on a decline in our trade deficit at least equal to the amount by which domestic demand is likely to slow, given the fact that we are now in the fourth year of the business expansion and spending usually takes a breather about this time.

To be sure, with the dollar down by nearly 25 percent against the currencies of our major trading partners, it is not unreasonable to expect a smaller trade deficit in 1986 compared with 1985. However, questions have arisen about which of our exports might be expected to rise to help close the trade gap, and which imports might fall. This is because the dollar has not declined uniformly against all currencies. Indeed, it has actually gone up against the currencies of a number of countries whose exports compete with ours abroad and/or whose industries sell primarily to our domestic markets (see Charts I and II). In addition, there seems to be

CHART I
U.S. DOLLAR DEPRECIATION VS. SELECTED CURRENCIES
(FEBRUARY 27, 1985 = 100)

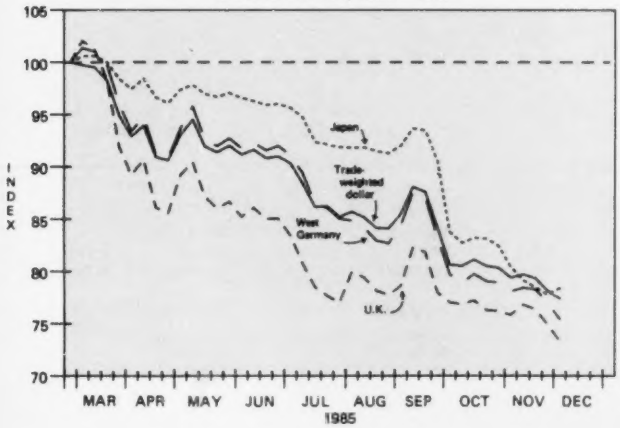
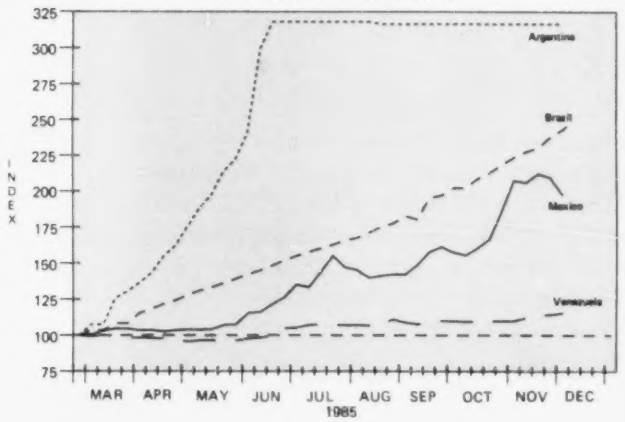


CHART II
U.S. DOLLAR APPRECIATION VS. SELECTED CURRENCIES
(FEBRUARY 27, 1985 = 100)



enough excess goods around, as well as the capacity to produce them, to tempt a number of countries to cut selling prices where their currencies have risen, in order to maintain market share.

Thus I thought it would be appropriate this month to dissect our merchandise exports and imports by country and by category to see whether our expectations of gradually declining imports and rising exports during 1986 are logical. Let us look at the import side first, since imports are roughly two-thirds greater in value than exports at the present time. As Table I indicates, our currency has dropped the most against those countries from which 44 percent of our imports originate. These items are machinery, transportation equipment, and chemicals and related products. What is more, these three categories together account for 34 percent of U.S. industrial production.

Lower Imports Are Likely ...

To be sure, there are some countries whose exports fall within these three categories whose currencies have declined against the dollar. However, for the most part, they are not major suppliers to the U.S. market. Thus, it seems sensible to expect that prices of machinery,

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transportation equipment, and chemicals and related products imports will soon rise, reflecting the decline in the value of the dollar. When they do, purchasers of these items will turn increasingly to U.S. sources. This would suggest a decline in imports and a corresponding fillip to domestic manufacturers.

As Table I also indicates, the dollar has appreciated against the currencies of all the major countries exporting to us two categories of goods: food and clothing. However, these items account for only about ten percent of our merchandise imports and about 13 percent of factory output. Obviously, one should not expect imports of these categories to slow—at least in response to currency changes—so those domestic industries which compete with these imports are likely to remain depressed unless demand picks up to a much greater extent than many now anticipate.

The dollar has also risen against the currencies of most of the world's oil producing countries. However, this is not likely to result in a surge of imports for several reasons. First, there is ongoing conservation. Ever since the first round of oil price increases in 1973-74, the U.S. has become progressively more efficient when it comes to energy use in general and petroleum products in particular. For 50 years prior to 1973, each one percent increase in the real gross national product required a one percent increase in energy input. In the dozen years since then, this ratio has been cut substantially.

A one percent increase in energy usage today can support up to a five percent rise in national output. Since the real GNP in 1985 most likely grew by only 2½ percent, and may not grow much more than 3½ percent in 1986, you can see where our usage of energy in general and petroleum in particular is declining and will probably continue to fall. Besides conservation, the umbrella created by the earlier increases in oil prices has encouraged the exploration and production of oil from both within the U.S. (the North Slope of Alaska) as well as from such areas as the United Kingdom—whose currency, the British pound, has risen against the dollar.

... While Exports Rise

Turning to exports, we find from Table II that the dollar has fallen substantially against the currencies of those countries competing with us in nearly 60 percent of the goods we sell abroad. These goods are in the machinery, transportation equipment, chemicals, and instruments categories. These same four categories account for nearly 37 percent of our industrial production. Thus, if these exporters pass along to their foreign customers the benefits of the decline of the dollar, they should soon experience a pickup in demand.

On the other hand, the dollar has either remained unchanged or has risen against the currencies of those countries which are major food exporters. In the case of Argentina, the rise has been quite substantial, as you can see. However, exports of food and live animals account for less than nine percent of U.S. exports and this category amounts to only eight percent of industrial production. Similarly, the rise in the dollar against the currencies of those countries which export refined petroleum products is somewhat mitigated by the fact that these exports account for only 4½ percent of total U.S. exports.

On the question of excess capacity, it may be true that both developed and developing countries are producing more goods than consumers are willing to buy—at least for the time being. Some observers have termed this a "glut economy," wherein overabundance has replaced the chronic shortages of a few years ago. The net result

TABLE I

TOP SIX CATEGORIES OF U.S. IMPORTS:

Major Source Countries and U.S. Dollar Depreciation or Appreciation since late February peak

Machinery [16.7%*]		Transportation Equipment [9.1%*]		Mineral Fuels, Lubricants & Related Materials [11.1%]		Food & Live Animals [8.0%*]		Clothing & Accessories [5.1%*]		Chemicals & Related Products [8.1%*]	
Share of U.S. Imports 21.7%		Share of U.S. Imports 17.5%		Share of U.S. Imports 15.3%		Share of U.S. Imports 5.6%		Share of U.S. Imports 4.6%		Share of U.S. Imports 4.3%	
Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)	Major Source Countries	$ Dep. (−) or App. (+)
U.K.	−26.7%	Germany	−25.5%	U.K.	−26.7%	Canada	+ 0.5%	Hong Kong	+0.1%	U.K.	−26.7%
Germany	−25.5	Japan	−22.3	Algeria	− 8.5	Taiwan	+ 1.4	Taiwan	+1.4	France	−25.7
Japan	−22.3	Canada	+ 0.5	Canada	+ 0.5	Philippines	+ 2.9	Korea	+5.5	Germany	−25.5
Singapore	− 6.3			Saudi Arabia	+ 1.4	Australia	+ 3.7			Japan	−22.3
Canada	+ 0.5			Indonesia	+ 2.7	Mexico	+ 97.0			Canada	+ 0.5
Taiwan	+ 1.4			Venezuela	+15.3	Brazil	+142.6				
Mexico	+97.0			Mexico	+97.0						

*Share of U.S. Industrial Production

Sources: Commerce Department, Federal Reserve Board, MH.

is falling prices, compared with the upward spiral that characterized the late 1970s.

However, just as the soaring prices of the 1970s ultimately carried the seeds of today's deflation, the same may be said for the current round of declining prices. The inflation of the 1970s, by raising the returns available on a wide variety of enterprises ranging from mining to farming to manufacturing, encouraged people either to enter these fields or to expand if they were already in them. Ultimately this resulted in a tremendous growth of capacity, which, in turn, created the conditions that exist today. It stands to reason, therefore, that falling prices will force people either to exit from these endeavors, or to contract their activities until only those who are profitable survive. This will ultimately shrink excess capacity and cause prices to firm once again.

Excess Capacity Should Shrink

At the moment, however, because of some countries' external debt problems, the ongoing softness in basic commodities' prices is causing an increase in production. This is because these countries must maintain—if not increase—their export revenues in order to service their external debts. Clearly the more they produce the lower prices will go, leading to even further production. This downward spiral can only be broken by an increase in demand, and such an increase seems to be on the horizon. For one thing, most of these commodities are denominated in dollars. Thus, the lower-valued dollar will boost the buying power of other countries and should lead to an increase in their purchases. Also, growth in the other major industrial economies must pick up soon, if the efforts of the Fed and the other major central banks to keep the dollar down are to remain successful.

I hope I have convinced you that our expectations of a shrinking trade deficit adding strength to the U.S. economy in 1986 are not extreme. Obviously, the gap between imports and exports will not go away anytime soon. Indeed, it may hold steady or even widen a bit in the near term. This is because of the distinct possibility that there may not be a change in prices of merchandise imported from those countries whose currencies have risen against the dollar. Some foreign exporters may wish to accept smaller profit margins, rather than lose share of market to U.S. producers. In view of the fact that many of them never lowered their prices to reflect their currencies' progressive weakness against the dollar between mid-1980 and early 1985, they would appear to have a substantial cushion with which they could absorb any decline in profit margins.

If foreign exporters do raise selling prices in the U.S., it would cut into the purchasing power of our citizens, thus causing them to spend less. Not only would the increase in prices of imported goods affect people's ability to buy them, but they might well be matched by price increases by domestic manufacturers, seeking to take advantage of the umbrella provided to restore their profits. Given recent experience with price inflation, however, I would not expect this to be much of a factor, this time around. People in all walks of life and business seem to be very resistant to price and cost increases.

Thus, I do believe that the trade picture will add to the economy in 1986 rather than subtract as it did in 1985. Remember, to stop subtracting from domestic output, all that is necessary is for our trade deficit not to widen any further. I think this is a reasonable expectation in view of the foregoing discussion. And to the extent that the trade gap actually shrinks a bit, it becomes a definite plus to our gross national product. H

TABLE II

TOP SIX CATEGORIES OF U.S. EXPORTS:

Major Competitor Countries and U.S. Dollar Depreciation or Appreciation since late February peak

Machinery [16.7%*]		Transportation Equipment [9.1%*]		Chemicals & Related Products [8.1%*]		Food & Live Animals [8.0%*]		Mineral Fuels, Lubricants Related Materials [11.1%*]		Professional, Scientific & Controlling Instruments & Apparatus [2.7%*]	
Share of U.S. Exports 28.2%		Share of U.S. Exports 16.3%		Share of U.S. Exports 10.4%		Share of U.S. Exports 8.9%		Share of U.S. Exports 4.5%		Share of U.S. Exports 3.1%	
Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)	Major Competitor Countries	$ Dep. (−) or App. (+)
U.K.	−26.7%	U.K.	−26.7%	U.K.	−26.7%	Canada	+ 0.5%	Algeria	− 8.5%	U.K.	−26.0%
France	−25.7	France	−25.7	France	−25.7	Australia	+ 3.7	Canada	+ 0.5	Germany	−25.5
Germany	−25.5	Germany	−25.5	Germany	−25.5	Argentina	+216.6	Australia	+ 3.7	Japan	−22.3
Japan	−22.3	Japan	−22.3	Japan	−22.3			Poland	+ 8.0	Canada	+ 0.5
		Canada	+ 0.5	Canada	+ 0.5			Venezuela	+15.3	Mexico	+97.0
								Colombia	+41.0		
								South Africa	+41.3		
								Mexico	+97.0		

*Share of U.S. Industrial Production
Sources: Commerce Department, Federal Reserve Board, MH.

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